Cooling the Residential Construction Boom

The interest-sensitive, red-hot housing sector has been the driving force behind the construction industry's job growth. Construction has been a primary source of U.S. economic activity in recent years.

Residential construction has been stimulated by record-low interest rates that have persisted for over three years. For example, from 2003 through 2005, the average annual interest rate on a fixed 30-year mortgage has been either 5.8 or 5.9 percent. The last time mortgage interest rates were at such low levels was in the early 1960s.

Spurred on by such a favorable interest rate environment, record numbers of new homes have been built; sales of existing homes have also skyrocketed. Annual housing appreciation, which varies significantly by local area, averaged double-digit increases nationally for the last two years. Financial institutions have also stimulated the housing boom by expanding creative financing techniques—no down payment, adjustable rate mortgages (ARMs), and interest-payment only loans—instead of more conventional loans with fixed annual rates. These conditions, along with high price appreciation and a relatively stagnant stock market, have also invigorated speculative housing investment.

Low interest rates also benefit business, commercial, and government construction. The dollar value of these non-housing construction activities expanded by 6.3 percent from 2004 to 2005, compared to a growth rate of 11.2 percent for residential construction. Such high levels of construction activity have provided new jobs, with construction employment increasing by 4.3 percent last year. In comparison, U.S. job growth among all nonfarm industries was 1.5 percent during 2005.

Since October of 2005, mortgage interest rates have taken a definite, although gradual, upturn. As a result, residential construction appears to be softening as sales diminish and price appreciation fades. Speculative housing investment and prices in many of the recent highflying markets are moderating.

In the past two years, more than 30 percent of all mortgages written have been ARMs. Over the coming year, many of these mortgages will be reset to higher interest rates, increasing the monthly payments significantly and reducing their disposable income.

Most economists see a downward trend in the outlook for residential construction. This should not be a severe movement. Even with higher interest rates, rising overall employment growth and incomes in the economy, along with the continuing reconstruction in the hurricane ravaged gulf-coast states, will help support the national housing markets.